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CALIFORNIA AGRICULTURE: 1987 SITUATION AND OUTLOOK

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I. SUMMARY

The business outlook for California agriculture through 1988 is mixed. The prosperity of growers, merchants, and processors will depend on the segment of the industry with which they deal.

The economic factors that brought about the downturn in agriculture from 1981 through 1986 have largely been reversed: The exchange value of the dollar has fallen below its 1979/1980 levels; interest rates, although beginning to inch up, still are at their lowest levels in years; and world economic growth has reappeared since the 1981/1982 recession. Many producers of specialty crops are beginning to benefit from these improvements. Exports of fruits and vegetables, for example, were up 30 percent in the fourth quarter of 1986 compared to the fourth quarter of 1985. However, problems persist in those crops that are in surplus, such as grains, because of worldwide government subsidies.

The state's current agricultural situation and the medium-term outlook can be categorized in the following three ways:

Positive - For roughly 35 percent of the industry -- fruit, nuts, wine, and nursery products -- the outlook is bright. Prices and farm incomes will improve as lower production levels remove surpluses and the declining value of the dollar boosts sales.

Stable - For another 25 percent of the industry -- dairy, cotton, sugarbeets, and grains -- the outlook is for stability. Despite tremendous surpluses and low market prices, government program payments will keep farm income elevated.

Competitive - For the remaining 40 percent of the industry -- vegetables, non-subsidized field crops, and cattle -- the outlook is for a continuation of the difficulties of the past six years. There are some signs of improving demand; but, unfortunately, there are new producers, both domestic and foreign, who are increasing production of these commodities.

This mixed situation within the agricultural industry is evident in trends in commodity prices, farm incomes, and land values. Success or failure for individual firms, however, will not be solely determined by the

commodity sector in which they operate. Opportunities and risks also are associated with international integration of commodity production, land quality, environmental legislation, and government policy.

II. ECONOMIC ENVIRONMENT

The overall global economic situation now favors recovery for segments of the U.S. and California agricultural industry. Exchange rates and interest rates are beginning to benefit the U.S. farm economy. Nevertheless, major structural shifts in the world agricultural economy will prevent some growers from recovering. The fact remains -- overall the outlook for U.S. and California agriculture is mixed.

Some specific predictions include:

Growth - The U.S. and world economies will continue to grow slowly through 1988. Interest rates will remain near current levels and inflation will increase slowly. The U.S. budget deficit will be reduced somewhat.

Trade - With the declining value of the U.S. dollar, this country's agricultural trade balance with Japan and Europe will improve for specialty crops. However, the agricultural trade balance with other nations will not improve as quickly because of the continued strength of the U.S. dollar against many currencies, such as the Hong Kong and Australian dollars, and the Korean won.

Commodity Prices - Prices will remain volatile. Worldwide production subsidies will keep basic commodities -- cotton, grains, soybeans, sugar -- in surplus for the foreseeable future.

Legislation - Provisions of the 1985 Farm Bill will remain largely intact through 1988. Expected changes will include increased incentives to reduce acreage and more stringent payment limitations.

Tax Reform - The Tax Reform Act of 1986 will remove a large source of equity capital from agriculture, adding to the non-liquidity of the farmland market.

Acreage - Bearing acreage of most permanent plantings will decline through the end of the decade. Field crop acreage, especially that with high water costs, will also decline.

Production - Third world nations will increase production of most farm commodities. The focus of many developing nations' agricultural policies will be on value-added food products, such as processed fruits and vegetables.

III. COMMODITY PRICES AND FARM INCOME

The financial stress of California farmers during the past four years was created by the rapid rise in interest rates and the deflation of commodity prices in the early 1980s. This combination caused the net income of farmers to deteriorate and land values to plunge. In most cases farmers with heavy indebtedness were unable to meet their loan payments. In recent years interest rates have fallen and debts have been restructured, improving farm-sector economics. Still, in many cases commodity prices have continued

to decline. The outlook for individual sectors, therefore, largely hinges on when commodity prices will reach a level that will provide a profit to producers.

Table 1, shown below, presents the farm commodity price trends for 10 top California commodities. The commodities are segmented into three categories -- positive, stable, and competitive -- reflecting the outlook for prices and farm incomes. Following the table is a discussion of the outlook for the various segments of the California farm economy.

TABLE 1
Farm Commodity Prices

	1985	1986
Positive		
Almonds ($/Pound)	$ 0.68	2.20
Prunes ($/Ton)	$650.00	800.00
Raisins ($/Ton)	$500.00	650.00
Wine grapes ($/Ton)	$ 65.00	95.00
Stable		
Cotton - Gov't Price ($/lb)	$ 0.57	0.65
Market Price ($/lb)	$ 0.55	0.58
Rice - Gov't Price ($/cwt)	$ 6.80	6.50
Market Price ($/cwt)	$ 7.00	4.00
Sugarbeets ($/Ton)	$ 32.00	32.00
Milk ($/cwt.)	$ 11.78	11.86
Increasing Competition		
Alfalfa ($/Ton)	$ 75.00	65.00
Tomatoes (Processing)($/Ton)	$ 50.00	47.00
Beef ($/cwt.)	$ 48.00	46.00

Source: California Crop and Livestock Reporting Service 1985, 1986.

Orchards and Vineyards - Prices for fruit and nut crops, as illustrated by almonds and prunes, rose dramatically from 1985 to 1986. The improvement came largely as a result of shortages caused by bad weather. Although prices improved because of reduced yields, farm income for many growers did not. Genuine improvement in income for specialty crop growers can be expected in 1987 for the following reasons. Last year's shortages have depleted inventories, bearing acreage has been reduced, and sales are improving with the falling value of the dollar.

Nursery, Flowers, Citrus, and Poultry - Although prices for these commodities are not shown in Table 1, these sectors have outperformed the industry consistently during the past four years and can be expected to continue to do so. Sales of nursery and citrus products will benefit from the falling dollar, and poultry producers' income will improve because of cheap feed prices.

Grains and Cotton - Table 1 illustrates the divergence between the market price and the government-supported price for cotton and rice. Government payments are keeping the returns received by subsidized producers well above market levels. The government-supported prices can guarantee low-leveraged producers a profit. However, for both cotton and rice, the projected market prices in 1987 are below cost of production for most producers. The cotton industry is in much better shape, at least through 1987, than the grain industry because China, the world's largest producer and user of cotton, is reducing output.

Dairy and Sugarbeets - For sugarbeet and dairy producers the prices received are determined by the government and are well above unprotected world prices. These industries are protected through a mix of tariffs and government guaranteed prices. With continued federal support, these industries should be stable.

Vegetables and other non-supported field crops - The price trends, as illustrated in Table 1 by alfalfa and tomatoes, can be characterized as volatile and generally downward. Downward trends are largely caused by increasing production levels. New technologies are allowing producers in the United States and overseas to produce vegetables on soil that previously had been considered inadequate. Cotton and grain farmers who have land that does not qualify for government subsidies are attempting to produce vegetables and other non-subsidized commodities using these new techniques.

Cattle - The short-term outlook for cattle is good -- beef prices are up and feed prices are down. Even after large reductions in herd size, however, cattle producers in the state will face continued competition from other states and nations. Because of the high number of beef packing operations that have left the state, California producers have a cost disadvantage compared to many other cattle producing states.

IV. LAND VALUES

Land values have followed the path of commodity prices. As shown in Table 2 below, between 1981 and 1986 per acre values for most farmland fell dramatically. For the improving segments of the industry, however, an increasing number of buyers are in the market for top-quality ground. During the past six months, the values of top-quality orchards and vineyards have appreciated. Prices offered for most premium field crop acreage have remained stable. However, the market for marginal field crop ground and pasture land is almost nonexistent.

TABLE 2
California Farmland Values

	1981	1986	Percent Change 81-86
	(dollars per acre)		
Vineyards			
San Joaquin Valley	$10,725	3,928	-63.4%
Napa, Sonoma	$15,951	17,500	+9.7%
Almonds	$10,100	4,450	-55.9%
Other Tree Crops	$13,220	10,952	-17.1%
Row Crop			
San Joaquin Valley	$ 3,867	2,233	-25.7%
Sacramento Valley	$ 3,760	2,476	-34.1%
Pasture	$ 520	370	-28.8%

Source: Bank of America Appraisal Department (Not statistically valid. Figures are based on a statewide sampling of properties that are annually reappraised by the bank's Appraisal Department.)

V. OPPORTUNITIES

The prospect of improved commodity prices, plus other trends, some of which are discussed below, promise opportunities for profitability and growth for many agricultural firms.

International Integration - Fresh produce firms are moving toward international sources of commodities. In the past, a successful produce operation needed to be able to obtain produce from growers in Salinas, Santa Maria, the Imperial Valley, and Arizona. Increasingly, however, a successful produce operation will need fruit and vegetables from New Zealand, Chile, and Mexico, as well as California.

Land Appreciation - The potential for appreciation of orchards and vineyards has been enhanced by economics and federal tax reform. Quality permanent plantings are currently being sold for half of their replacement value. When shortages develop, the land values will have to appreciate in order to attract new plantings.

Wine Industry Turnaround - The wine industry is in the process of turning around. Imported wine prices are increasing with the declining value of the dollar, and sales of imported wines in the United States are falling. As a result California wineries, especially in the premium segment, are winning the battle for market share in an expanding market.

Government Support Payments - These payments provide stable and profitable incomes for small holdings of cotton and grains. Because of payment caps, five 200-acre cotton farms are worth up to twice as much as one 1000-acre cotton farm.

A Secondary Market for Farm Mortgages - This legislation is likely to be passed by Congress this year. This market will create opportunities for lenders to provide mortgage origination services without taking on the risk of holding farm mortgages in portfolio. With passage of this legislation, liquidity in the farm mortgage market would increase.

IV. RISKS

In addition to the water, weather, and economic problems usually associated with agriculture in the state, California agriculture faces additional risks that will determine success or failure:

Environment - Producers are under increasing pressure to reduce the use of toxics. Producers who misuse pesticides face a growing risk of fines and lawsuits.

Government Cutbacks - There is pressure in Congress to reduce government support to cotton and grain producers. Although unlikely, these reductions would destabilize those industry segments.

Financial - When forced to take action against borrowers, lenders face costly lawsuits and difficult legislative hurdles, including the new Chapter 12 bankruptcy law. Faced with such hurdles, some lenders may become increasingly selective.

Labor - Immigration reform will limit the supply of labor in the state, raising production costs for California producers vis-a-vis foreign producers.

Marginal Land - Institutions, including banks and insurance companies, own more than 600,000 acres of farmland in the state. With such large volume of land for sale, farmland values for marginal land will remain depressed for the foreseeable future.

VII. LENDING

Outstanding farm debt in the state has declined significantly. As shown in Table 3 below most traditional lenders -- the Farm Credit System, Bank of America, Wells Fargo Bank, Security Pacific, and insurance companies -- are reducing outstandings to the state's agricultural industry in reaction to unacceptable loss levels of recent years and current high risks.

TABLE 3
Outstanding Farm Debt In California
Farm Credit System and Commercial Banks
End of Year, 1984 to 1986

	1984	1985	1986	Percent Change 84-86
	(millions of dollars)			
Farm Credit System	$6,179	$5,597	$4,770	-23%
Commercial Banks				
Bank of America	$1,981	1,606	1,161	-41%
*Wells Fargo	$1,155	954	790	-32%
Security Pacific	$ 647	667	576	-11%
First Interstate	$ 187	184	140	-25%

Source: Farm Credit Administration, Federal Reserve Bank.

*Includes Crocker Bank's outstandings for 1984 and 1985

While most large lenders are pulling back, many non-traditional lenders, and small and mid-sized regional banks are attempting to develop new business in industry niches. These firms see opportunities in an industry at, or near, the bottom of a cycle. They are exploiting the negative image of the traditional lenders and providing financing for both operating lines and land purchases.

VIII. CONCLUSION

Although the decline in California's agricultural economy affected all segments of the industry, the recovery will not be nearly as widespread. A significant share of the industry will continue to face declining markets. A large number of agricultural producers, merchants, and processors, however, will become profitable and expand their operations during the remainder of the decade.